The institutional form of independent central banks: from history to contemporary challenges - speech by Andrew Bailey

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Speech

I would like to reflect on independent central banks as institutions, and how their authority is grounded and is challenged.

On 3rd September 1780 (246 years ago yesterday) a 23 year old aide to George Washington wrote that: “the Bank of England unites public authority and faith with private credit and hence we see what a vast fabric of paper credit is raised on a visionary basis.” That 23 year old was Alexander Hamilton.[1]

The meaning of central bank independence is not just a technical point about monetary policy or financial stability, or just a point about the design of public institutions. It is about the relationship between societies and the institutions they create to serve them. This brings to mind Douglass North's definition of institutions as the rules of the game in a society or, more formally, the humanly devised constraints that shape human interaction.[2]

Institutions are not just organisations. They are durable arrangements through which societies solve collective problems. To do this, they must embody understandings about how authority should be exercised, how conflicts should be managed, and how common interests should be protected.

Independent central banks are among the most distinctive institutions modern societies have created. They exercise important powers. Their decisions influence borrowing costs, saving decisions, employment prospects, investment plans and the broad stability of the financial system. Their powers, and how they are used, are always the subject of debate, and that's fair enough given the importance.

Now, there are critics of these arrangements. Some critics argue that central banks disproportionately reflect the interests of financial markets and financial institutions. In a similar, but distinct, spirit others argue that central banks are too detached from the preferences of citizens. These criticisms often differ in their origins and motivation, but they converge on a common question. Why should an unelected institution possess such significant authority?

My purpose today is not just to defend central bank independence, though you can be assured I am happy to do that robustly. Rather, it is to reflect on the deeper intellectual traditions from which it has emerged and to consider what those traditions can tell us about the challenges we face.

When economists explain central bank independence, they often begin with questions about the credibility of policy regimes and their time consistency. These arguments are important. They explain why in many countries independence emerged because governments at crucial times had demonstrated incentives to pursue short-term monetary policies that ultimately undermined economic stability, and to undercook financial stability outside more immediate proximity to a financial crisis.

But they do not fully answer a more fundamental question: why should society trust an institution that operates with a degree of independence from day-to-day political control? To answer that question, it is useful to look further back.

One important tradition begins with the French philosopher Montesquieu.[3] Writing in the eighteenth century, Montesquieu was preoccupied with the problem of concentrated power. His great concern was how societies could prevent authority (in that case royal authority) from becoming arbitrary. His answer was that power should be moderated through institutions that stood between rulers and citizens.

Parliaments, courts of law and other intermediary bodies performed this role. They constrained power, not simply through legal rules but because they possessed recognised standing within society. They had identities, traditions and sources of legitimacy independent of those they were intended to restrain. For Montesquieu, these roots mattered. Institutions could not simply be invented and expected to command authority. They required legitimacy that grew over time.

At first sight, modern central banks appear rather different. A central bank derives its authority primarily from legislation. Its independence is granted through statute. It does not rest upon inherited privilege, social rank, or customary authority. Modern central banks are deliberately designed to be technocratic institutions. And yet, the questions Montesquieu asked remain relevant. His central concern was how societies create institutions capable of constraining the exercise of power for the common good. In that sense, the challenge he identified remains with us.

A second intellectual tradition is also relevant. This tradition emerged from English political thought in the seventeenth and eighteenth centuries, and from debates about sovereignty, money and commerce. As David Hume put it, in the seventeenth century commerce, for the first time, became a “reason of state”.[4]

Thomas Hobbes provided one starting point in this development.[5] In the world of Hobbes, the authority to determine the value of money belonged to the sovereign. Just as the sovereign commanded armies and administered justice, so too the sovereign controlled the monetary system of the day, such as it was. Given this overriding concern with political order and stability, for Hobbes dividing authority over money risked dividing authority itself.

But this view was challenged. John Locke argued against the idea that governments should be able to alter the value of money according to political convenience.[6] During the monetary controversies of the 1690s, Locke insisted that arbitrary changes in the value of money damaged trust, disrupted commerce and undermined the public faith upon which economic exchange depended.

This marked a significant intellectual shift. Money was no longer seen just as an instrument of sovereign authority. It became something that served a broader public purpose. Its stability mattered not merely because government or the Sovereign desired it, but because society required it.

David Hume developed this argument further.[7] Hume observed that commerce had become central to the prosperity and strength of nations. Economic life was no longer peripheral to statecraft. It had become one of its defining concerns. Stable money and reliable credit systems became essential foundations for expanding commerce. They enabled people to transact, invest, save and plan with confidence.

In this tradition, monetary stability became a public good. It is from this intellectual lineage that modern central banking most directly emerged. The founding of the Bank of England in 1694 illustrated this evolution, reflecting two powerful forces.[8]

The first was the rapid expansion of trade and commerce. As markets became more sophisticated and more interconnected, the need for a stable and reliable monetary and financial framework grew.

The second was the necessity of financing war. In 1694, England's conflict with France created urgent demands for finance. The arrangement that established the Bank of England enabled private capital to be mobilised in support of public objectives.

One of the interesting points in The Spirit of the Laws is that Montesquieu linked England's financial credibility to its constitutional arrangements (comparing it to France). In England, public credit was not merely a matter of financial technique; it depended on institutions capable of generating public trust. This interpretation is entirely consistent with the quote from Alexander Hamilton.

But the opposite view is also powerful, as set out by John Pocock and summarised by Istvan Hont:-

“The understanding of commerce and commercial society in late seventeenth century England was most advanced by just those thinkers who saw the political health of the English nation as jeopardised by the pervasive corruption that resulted from the intrusion of the demands of the war economy into the sphere of domestic politics.” There was a growing awareness of the distractions which the new of kind of war finance, the running of a huge public debt, might cause to the balance of the English constitution. A political and military regime financed by the public debt implied a danger of the rising in influence of a financier class, which could exercise power without enjoying a proper and legitimate place in the politics of the country.[9]

One way to describe the importance of the growth of commercial societies is to show how they led to the emergence of some of the most profound issues of political economy, namely:

- The rise of nation states as economic and commercial agents in their own right;
- The need for a properly constituted system of sovereign power to settle internal and external disputes;
- The demand for state finance;
- The role of justice in economic distribution;
- The growth of elaborate divisions among economic interests;
- Greater complexity and opacity in the workings of economies; and
- The development of tools for authorities to modify the workings of markets, and the risk of a variety of motives for doing so.[10]

These issues remain at the heart of economic policymaking today. The early Bank of England was an important part of the development of commerce. It is however important to recognise that the original Bank of England looked very different from the institution we know today. It was not conceived as an independent guardian of monetary stability. It emerged from a partnership between government and a relatively small and concentrated group of financially sophisticated investors. And, unlike the modern institution, the early Bank was not removed from politics.[11]

The origins of the Bank align as much with Mancur Olson's later analysis of organised interest groups as with any modern idea of an independent public institution.[12] My point is not to criticise those origins. They reflected the realities of the time. But they do remind us that central banking did not emerge fully formed. It evolved gradually as understandings of money, credit, commerce and public authority evolved. Nonetheless, the big themes we wrestle with today were beginning to emerge at that time.

The modern central bank is therefore the product of a long historical process. On one hand lies the Montesquieu tradition, concerned with limiting arbitrary power through institutional checks. On the other lies the tradition of Locke and Hume, concerned with establishing money and credit as public goods upon which society depends.

Modern central banks bring these traditions together. Their essential purpose is to safeguard the stability of money including the resilience of the financial system. These are not interests that belong exclusively to any group. They are public goods from which society as a whole benefits.

The important distinction between the public interest and the public good, as set out by Brian Barry, is important in this respect.[13] Individual citizens naturally have different preferences, priorities, and interests. Democracies exist in part to sort out those competing claims. But some goods are valuable to the public as a whole precisely because they are universally shared.

Monetary and financial stability is one such good. Whatever our views on taxation, spending, regulation or public services, we all operate within a common monetary and financial framework. The value of money is something upon which every household and every business rely. To be effective in the sense of trust and legitimacy in society, support for such a public good should come from the plurality of society rather than any single member group.

This does not mean that monetary policy and financial stability are devoid of distributional effects. Interest rates affect borrowers and savers differently. Financial stability policies can affect sectors and institutions in different ways. Public policy inevitably has consequences that are not distributed uniformly.

But recognising those consequences should not obscure the broader purpose that these policies serve. The objective is not to favour one group over another. It is to preserve the monetary and financial conditions that make sustained prosperity possible.

In that sense, central bank independence represents a modern adaptation of Montesquieu's thinking. The institution exists not to accumulate or counter arbitrary power but to protect the value of money from short-term pressures that could damage the public interest. But this arrangement also creates an enduring challenge.

Unlike the institutions that Montesquieu had in mind, central banks do not possess deep social roots of their own. Indeed, they must be careful not to become identified with any single interest group. A central bank that became closely aligned with particular sectors or political movements would undermine the very rationale for its independence, and therefore its legitimacy

As John Dunn has argued, this gets us to the issue of the constitutional theory of how power can be institutionalised and thus be implemented effectively in practice. This is the critical relationship between "the constitutional order of power and the pragmatic determination of economic policy". It's the modern version of the problem Montesquieu identified and sought to solve. As Dunn notes, constitutional order can appear very settled and continuous, whereas economic policy can appear anything but at times. Writing in the mid 1980s, Dunn argued that a constitutional order which rendered the benign conduct of economic policy more likely than not had not yet been constructed. Solving this challenge has been critical for the legitimacy of modern central banks.[14]

So where does legitimacy come from? The answer, I believe, is now straightforward. Modern independent central banks are not independent of democratic government in the important sense that their authority originates in legislation or the like enacted by elected representatives. In the Bank of England’s case, Parliament defines the objectives, establishes the powers, and retains the authority to amend the framework within which we operate. This role is critical.

This brings me to the contemporary challenge. Across many countries we have witnessed growing scepticism towards public institutions generally. In the case of central banks, as I mentioned earlier, some critics argue they are too close to financial interests and that they stand in the way of popular preferences.

This challenge is not new, but some aspects of it are sharply set out at present, particularly in the area of financial regulation. The argument goes that central bank policies affect the distribution of returns, wealth and welfare directly, which pulls economic interests back into the picture. This concern applies more to financial stability policy than to monetary policy, though monetary policy is not immune from it. One version of the criticism is that the central bank remains too close to financial interests. A central bank's usual response is that the public good of stable money substantially outweighs any distributional effects. But this response can return the argument to Olson's thinking, since the financial world does contain well organised and concentrated interests.

The irony is that central banks can, and today do, face an opposite accusation from the financial interests themselves, who argue that regulation has gone too far. So, criticism arrives simultaneously from two directions that contradict each other.

The fact that criticism can come simultaneously from opposing directions does not prove that central banks are correct. On their own, two perceived wrongs don’t make a right. But it does underline that independence often requires making decisions that do not align with the private interests of any constituency or group, and that at times resisting pressure from the concentrated interests that Mancur Olson identified is part of the task of protecting a public good like the value of money.

A second challenge comes from populist political movements. As Jan-Werner Müller has argued, populism often rests on the claim that a particular political movement alone represents the authentic will of the people.[15] Put thus, the public interest is something that a single ideology can capture and deliver directly. This effectively collapses Barry's distinction between the public interest and the public good.

Any institution seen to get in the way becomes an unrepresentative elite standing between the people and their will, and thus an obstacle to popular sovereignty. This is a serious challenge. We have developed systems of government (in the broadest sense of this term) in which legitimacy rests in the plurality of society, not in the preferences of any single group within it. Courts of law, universities, regulatory bodies and central banks all derive authority through forms of democratic delegation set within a framework of that plural society.[16] Maintaining the trust that goes with that delegation matters deeply.

Central banks cannot take legitimacy for granted. They must explain their decisions clearly. They must engage openly with the public. They must remain accountable to elected representatives for their statutory objectives. In our case that means the Treasury Select Committee of the House of Commons. Through this engagement and accountability, we must demonstrate how our actions serve the public good, in its traditional meaning.

Let me conclude. Institutions that exercise significant authority should expect scrutiny. Such scrutiny is a sign of democratic health. But we should also recognise what is at stake.

Sustained economic prosperity depends upon confidence in the future. Households must be able to spend and save. Businesses must be able to produce and invest. Financial markets must be able to allocate capital efficiently. All of these activities rely upon confidence that the value of money will remain stable including that the financial system will remain resilient.

Those conditions cannot be created overnight. They depend upon institutions that are trusted, durable and credible. Central bank independence does not mean detachment from democracy. It means insulation from short-term political pressures within a democratic framework. Its legitimacy derives from a parliamentary delegation and accountability goes with that independence. It is the basis on which independence legitimately rests.

In our own time, as in previous generations, the challenge is therefore not to weaken that foundation but to strengthen it: through accountability, through transparency, through public engagement and through an unwavering commitment to the public good of sound money that independent central banks exist to serve.

Thank you.

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11. Lord Macaulay, observed that "the weight of the Bank, which was constantly balanced in the scale of the Whigs, almost counterbalanced the weight of the Church, which was as constantly in the scale of the Tories". Thomas Babington Macaulay, The History of England from the Accession of James II, vol IV, ch XX (various editions),p556.

    By 1781, Prime Minister Lord North forcefully advocated for the Bank's charter renewal on the basis that the Bank had become so important to national credit and public finance that it could no longer be treated as an ordinary private corporation and had assumed *de facto* constitutional status, or at least a distinctive status within the executive branch. North had started his career as a Whig, but by this time was more aligned with the Tories.

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16. On this point, see: Rawls, J., A Theory of Justice, (Belknap Press of Harvard University Press, 1971).

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